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SBA

Business Basics

Cost Control

A Self-Instructional Booklet
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KEEP THIS GUIDE SHEET -- FOR INSTRUCTOR'S USE ONLY

COST CONTROL

Instructor's Guide Sheet

This booklet contains:

1. Excessive Costs
2. Cost Comparisons (Actual Costing and Accrual Accounting)
3. Evaluating Cost Data for Current Cost Performance
4. Percentages in Cost Evaluating
5. Evaluating Fixed and Variable Costs
6. The Profit Center Concept
7. Relevant Costs/Decision-making
8. Cost Allocations
9. Labor Costs
10. Cost of Purchases
11. Receiving Procedures
12. Regular Cost Review

Supplementary Instruction:

1. Using local trade association or published data, relate average industry costs to the client's account classifications.

2. Compare the client's current costs with costs in previous periods and industry averages, as applicable.

3. Develop objectives for each cost so performance may be compared simply and directly with budget data.

4. Identify apparently excessive costs, determine the cause of the problem, and recommend corrective action.

5. Establish a system of profit centers, if applicable.

6. Analyze typical managerial decisions in which consideration of direct and indirect costs is required.

7. Review the client's purchasing and receiving procedures.

NOTE: Prior to taking this booklet, the participant should have completed the booklet, Understanding Costs.

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INTRODUCTION

You can increase your profits dramatically through more effective control of your costs. For example, if your current costs are 95 cents of each dollar in sales, reducing costs by 1% to 94 cents would give you a 20% increase in profits, from 5 cents to 6 cents. That 20% increase in profits comes without having to increase sales. Each additional penny that you can cut from costs represents another 20% increase on your original net income.

Observation

To some extent, owners can control the costs of their business through observation. Material waste, labor inefficiencies, and other lax practices can be eliminated simply through observation and prompt action.

Systematic Review and Control

Personal observation alone is usually insufficient to control all costs of doing business or to maintain control on a continuing basis. In order to maintain effective control, you must review your cost structure on a regular basis and adhere to systematic procedures for identification of cost excesses. By isolating those specific areas where costs appear to be excessive, you can direct your efforts in initiating corrective action.

Policies and Procedures

To be sure that the corrective action that you initiate is pursued diligently, you must establish policies and procedures that will protect you from waste and inefficiency such as excessive labor costs, unnecessary purchases of goods and services, and overpayments to suppliers.

Booklet Objectives

This booklet has been prepared to help you control the costs of operating your business. In this booklet, you will learn how to do the following:

- Identify excessive costs that require corrective action.
- Review your entire cost structure on a continuing basis so that problems can be detected as early as possible.

- Use cost information properly for decision-making purposes.
- Control the cost of labor.
- Control the cost of purchased goods and services.
- Avoid the waste that can occur through improper procedures for receiving materials and processing payments to suppliers.

THE INCOME STATEMENT

Information Source

The income statement (profit and loss statement or operating statement) is the basic information source for cost analysis in most businesses. A typical income statement is shown on Exhibit 1. This income statement has been prepared for Village Hardware, Inc., a typical small retailer. The income statement summarizes the following:

- Sales during the year, 1979. The amount shown for sales includes all revenue earned whether it was received in cash during the year or charged to a customer's account and paid at a later date.

- Cost of goods sold. This amount is Village Hardware's cost of acquiring those goods that were sold to customers during the year and represented by the revenue reported above.

- Gross profit. The difference between the revenue realized from sales and the cost of goods sold.

- Operating expenses. These are the expenses of conducting the business other than the cost of merchandise sold to customers. It includes salaries, occupancy expenses, and various other expenses incurred during the course of the year.

- Net profit (before income taxes). This is determined by subtracting total operating expenses from gross profit. In other words, it is the revenue realized from sales minus all costs incurred during the year.

Cash vs. Accrual

Some businesses prepare their income statements on a cash basis. The only revenue included in the sales account is that actually received in cash during the period. The only costs reported on the statement are those actually paid in cash during the period. This approach is convenient for many small businesses and may, in fact, offer income tax advantages in some cases. However, it is not an entirely accurate method of measuring net income. For example, salaries earned by employees in a certain period or the rent for a building during the period should be considered an expense of the period, regardless of the date when the amounts are actually paid.

Income statements that recognize revenue during the period when it is earned (although not necessarily collected) and costs during the period when they are incurred (although not necessarily paid) are called accrual basis statements and are generally regarded as a more accurate measure of net income. Therefore, this module will assume that the income statement has been prepared on an accrual basis when using the statement for cost analysis.

In many cases, differences between a cash basis statement and an accrual basis statement may be immaterial. This is particularly true of businesses with stable patterns of sales and inventory purchases, prompt payments to suppliers, and timely collection of accounts receivable.

NOTE: Cover the correct answers and write your answers on a separate piece of paper (or in the book). Check your answers and review weak areas. Do all the exercises the same way.

1. The most important source of cost information in a business is the _____ statement.

---

income (profit and loss or operating)

---

2. On the income statement, the original cost of acquiring goods sold to customers during the period is called _____.

---

cost of goods sold (cost of sales)

---

3. Gross profit is determined by subtracting (COST OF GOODS SOLD/OPERATING EXPENSES) from sales.

COST OF GOODS SOLD

---

4. To determine net profit (before taxes), you would subtract:

   a. operating expenses from sales
   b. operating expenses from cost of goods sold
   c. operating expenses from gross profit

---

   c. operating expenses from gross profit

---

5. The cost of an item purchased for resale to a customer and sold during the period would be considered:

   a. a cost of goods sold
   b. an operating expense

---

   a. a cost of goods sold

---

6. The cost of an item used in the business during the period would be considered:

   a. a cost of goods sold
   b. an operating expense

---

   b. an operating expense

---

7. An income statement that reports only those sales for which cash was collected during the period and only those expenses for which payment was made during the period is called:

   a. a cash basis statement
   b. an accrual basis statement

---

   a. a cash basis statement

---

8. The principal advantage of cash basis statements in small businesses is:

   a. convenience
   b. accuracy

---

   a. convenience

---

9. Which basis offers a more accurate measure of net profit?

   a. cash
   b. accrual

---

   b. accrual

---

* * * * *

Cost of Goods Sold

Cost of goods sold has been defined as the business' cost of acquiring the goods that were sold to customers during the period. In most cases, this would include only the actual purchase price for the goods. However, some businesses also include as cost of sales the cost of freight from the supplier and handling charges for placing the merchandise in inventory. In other words, cost of goods sold would be the cost of making the goods available for sale to customers.

Determining Cost of Sales

The most precise method of determining cost of sales is to record the actual cost of each item sold during the period. In many businesses, this can be done without much difficulty. Businesses that have a substantial portion of credit sales prepare an invoice for every sale. The invoice details the merchandise actually sold. Since the accountant has an exact record of the goods that were sold, the cost of each item can be determined.

Some retailers prepare invoices for all major sales, whether cash or credit. These invoices can then be used for determining the cost of each item sold.

Other retailers, particularly clothing, attach price tickets to every item. A portion of the price ticket is kept when the sale is made to be used for costing purposes.

Average Costing

In some businesses, individual costing is not always practical. This is particularly true in businesses where sales include a large number of small items, sold principally for cash. For example, it would be inconvenient for a newsstand to record the cost of each newspaper, candy bar, magazine, or package of cigarettes sold to customers. Therefore, average costing is often used. If prices have been set to produce a gross profit (gross margin or markup) percentage of 40%, cost of goods sold as a percentage of sales can be determined as follows:

Cost of Goods Sold % = 100% - Gross Profit %

Cost of Goods Sold % = 100% - 40%

Cost of Goods Sold % = 60%

Group of Department Averages

Average costing can be reasonably precise, particularly if separate percentages are established for different product groups or selling departments. Each sale entered in the cash register includes a code to indicate the product group or selling department. Cost of goods sold can then be determined with reasonable accuracy by applying the appropriate percentage to each department or group.

Reconciling Cost of Sales

Periodically, cost of goods sold must be reconciled through a physical inventory. This is particularly important with average costing when markdowns, price specials, quantity discounts, or variations in product mix can disturb the accuracy of the averages used. While adjusting the actual cost of sales for the period prior to the physical inventory, new and more accurate averages can be established for the coming period.

327-431 O - 80 - 2

* * * * *

1. Which of the following methods is a more precise measure of cost of goods sold?

   a. individual item costing
   b. average costing

---

   a. individual item costing

---

2. What is the principal advantage of average costing?

   a. convenience
   b. accuracy

---

   a. convenience

---

3. In which of the following situations would average costing be more appropriate?

   a. a business that sells a small number of high-priced items

   b. a business that sells a large number of low-priced items

---

   b. a business that sells a large number of low-priced items

---

4. In businesses that sell entirely on credit, individual costing is usually practical. (TRUE/FALSE)

   TRUE

---

5. Which of the following is most likely to use average costing?

   a. a neighborhood grocery store
   b. a retailer of large appliances
   c. a wholesaler of food products

---

   a. a neighborhood grocery store

---

* * * * *

Operating Expenses

Operating expenses include all costs of conducting the business other than those included in cost of sales. The following are typical operating expenses:

. Salaries and wages.

. Occupancy expenses such as rent, utilities, and maintenance.

. Goods purchased for use in the business such as supplies and stationery.

. Services purchased for use in the business such as legal fees, accountants' fees, and advertising.

. Depreciation of fixed assets.

On the income statement, operating expenses are included during the period when the goods or services are actually used by the business, not necessarily when they are paid for. For example, salaries and wages earned by employees in January would be included as an operating expense in January even if they were not paid until a later date.

The basic sources of information used to record operating expenses are as follows:

. Salaries and wages. This information can be taken from payroll records.

. Goods and services purchased from outside suppliers. Suppliers' invoices are the usual information sources.

. Other operating expenses. For certain expenses such as interest and depreciation, the business does not receive

regular invoices. Therefore, the accountant normally determines the amount owed in each period and makes an entry in the books accordingly.

* * * * *

1. Costs incurred in the business other than those incurred to acquire merchandise for resale to customers are called _____ expenses.

---

operating

---

2. A stationery store's cost of acquiring letterheads for resale to customers would be considered:

   a. a cost of sales
   b. an operating expense

---

a. a cost of sales

---

3. The stationery store's cost of acquiring letterheads for its own use would be considered:

   a. a cost of sales
   b. an operating expense

---

b. an operating expense

---

4. Operating expenses are recognized on the income statement in the period:

   a. when the goods or services are used
   b. when the goods or services are paid for

---

a. when the goods or services are used

---

* * * * *

PROBLEM IDENTIFICATION

Cost control begins with the identification of those accounts where expenses are apparently excessive. This could be done by comparing actual costs either in total dollars or as a percentage of sales with any of the following guidelines:

- Performance in previous periods. By comparing expenses from one period to another, it is often possible to identify excesses or adverse trends.

- Industry averages. Your actual expenses can be compared with similar businesses in your industry so that you can determine any areas where your expenses are apparently excessive and could be more closely controlled.

- Objectives. Many businesses set objectives for every element of cost. Objectives are usually presented in the form of an income statement which states what sales, costs, and profit should be in the coming period. Actual sales and costs can then be compared with objectives to determine areas where performance must be improved in order to achieve the profit objective.

* * * * *

1. Excessive expenses are usually identified by comparison with _____.

---

guidelines

---

2. Identify three common guidelines for each comparison.

   1.
   2.
   3.

---

past performance
industry averages
objectives

---

3. Comparing your expense for supervisory salaries in December of 1979 with your experience in December of 1978 would be an example of a comparison based upon:

   a. past performance
   b. industry averages
   c. objectives

---

   a. past performance

---

4. You find that your delivery expense is 2% of sales and other businesses in your industry have delivery expense of just 1% of sales. This is a comparison with _____.

---

   industry averages

---

5. Comparing operating expenses with budgets established for each expense account is an example of a comparison with _____.

---

   objectives

---

* * * * *

Industry Averages

Industry averages are normally available from trade associations. Depending upon the particular association, these could include detailed breakdowns of each item of expense expressed as a percentage of sales. Frequently averages are available for businesses of varying sizes within the industry. They may be reported separately for high- and low-profit businesses.

If industry association statistics are not available to you, you may get information from business reporting firms which publish brief summaries of industry statistics for virtually every industry in the United States. These are ordinarily available at your local public library. Although they do not provide the detail available from industry associations, they can often provide useful guidance for cost control.

Past Performance

When comparing your costs of doing business with your own past performance, you must bear two factors in mind as follows:

. Comparisons must be based upon comparable periods. This is particularly important in seasonal businesses. For example, a business that relies heavily upon Christmas sales will learn little by comparing its December sales with average monthly sales throughout the year.

  It is also important to recognize that judging current performance based only upon comparison with your own previous performance can perpetuate mediocrity. Therefore, it is best to compare performance with similar profitable periods.

. Objectives. A later module will discuss the establishment of objectives in more detail. Properly established, objectives can combine a number of factors such as industry averages, past performance, and current economic conditions. With a formal system of objectives for all elements of cost, comparisons can be made quickly so that problem areas can be rapidly identified.

Averages

When analyzing costs, it is often useful to express each cost as a percentage of sales as shown on Exhibit 1 for Village Hardware. For example, cost of goods sold in 1977 is shown as 65% of sales and owner's salary is shown as 6% of sales.

The use of percentages is particularly appropriate when analyzing variable operating expenses. Variable operating expenses are those that tend to change in direct proportion to changes in sales volume. For example, delivery expense on Exhibit 1 is shown as $1,000 or 0.5% of sales. In a period when sales are higher, delivery expense would increase in total dollars but should remain the same as a percentage of sales.

Analyzing Cost of Goods Sold as a Percentage of Sales

The most important variable cost in retailing or wholesaling operations is ordinarily cost of goods sold. Analysis of cost of goods sold as a percentage of sales can indicate either of the following:

. Competitiveness of pricing.

. Cost control in purchasing goods for resale.

The conclusions you draw from examination of cost of goods sold as a percentage of sales must consider whether or not you feel that your pricing is competitive.

For example, if your cost of goods sold is apparently high, and your prices are competitive, then it is probably safe to conclude that your purchasing costs are high. On the other hand, if cost of goods sold as a percentage of sales is apparently low, but your prices are relatively high, then the apparently favorable percentage may only reflect your higher prices, not control of purchasing costs.

Effect of Average Costing

If your cost of goods sold is determined by average costing rather than individual costing, analysis of cost of goods sold as a percentage of sales may also be misleading. Accurate percentages would only be available when a physical inventory was taken so that an actual cost of goods sold could be determined.

Analysis of Fixed Expenses

Fixed expenses are those that do not tend to change as a direct result of changes in sales volume. They should remain about the same in dollar amount from month to month. Therefore, when comparing your actual fixed expenses with your performance in previous periods or with your objectives, these comparisons are usually more valid in total dollars than in percentages.

Percentages are ordinarily used only for analysis of fixed expenses when making comparisons with industry averages. Because the volume of sales from one business to another used in compiling the industry averages can vary widely, these expenses can only be expressed as a percentage.

This might seem to indicate that comparisons with industry averages have no validity for fixed expenses. However, this is not the case.

If you are to be profitable over the long term, your fixed expense in any account, expressed as a percentage of sales, should be comparable to the industry average. If unique characteristics of your business prevent you from staying at or below your industry average in a particular account, this differential must be offset by higher prices or economies in other expense accounts if you are to be consistent with the industry in generating net profit.

* * * * *

1. Variable expenses are best evaluated as:

    a. dollar amounts
    b. percentages of sales

---

    b. percentages of sales

---

2. Fixed expenses are usually best evaluated as:

    a. dollar amounts
    b. percentages of sales

---

    a. dollar amounts

---

3. In which of the following cases would analysis of fixed expenses as a percentage of sales be appropriate?

    a. comparison with objectives
    b. comparison with past performance
    c. comparison with industry averages

---

    c. comparison with industry averages

327-431 O - 80 - 3

4. Costs that tend to vary in proportion to changes in sales are called (VARIABLE/FIXED) expenses.

VARIABLE

---

5. Costs that tend to remain the same despite changes in sales are called _____ expenses.

---

fixed

---

6. Refer to Exhibit 2. In which of the following accounts does Village Hardware apparently have costs above the industry average?

   a. owner's salary
   b. clerical salary
   c. rent

---

b. clerical salary (4.0% vs. 1.3%)

---

7. In which of the following expense accounts does Village Hardware apparently have more effective cost control than the industry average?

   a. payroll taxes
   b. utilities
   c. miscellaneous

---

c. miscellaneous (0.0% vs. 1.4%)

---

* * * * *

Common Sense

Besides the formal analytic tools for identifying excessive expenses, the application of common sense is often highly productive. To some extent, your eyes and ears reveal excessive costs. Observations of waste, idleness, and inefficiency will be a signal for action.

Common sense can also be applied to examination of your income statement. When you look at the income statement, don't accept all costs as being inevitable. Ask questions such as the following:

. How did we spend this?

. What did we buy?

. Do we need it?

. Could we have bought it for less?

Account Analysis

Ask your accountant for breakdowns of individual expense accounts. For example, if your cost of office supplies looks high, ask the accountant for all the invoices that are included in the balance shown on the income statement. Examine each invoice to see if any items that were purchased may have been unnecessary or could have been bought for less.

Small Components

It is often useful to break down expenses into small components that can be more easily understood and analyzed than the gross dollar figures that appear on an income statement. Consider an expense such as photocopies. Perhaps your monthly cost is $200. Is this high or low? It might be easier to interpret if you know how many copies this represents. If you found that it is 2,000 copies a month, that's close to 100 a day, an easier figure to compare with your needs. Why do you need 100 copies a day? What is copied? How many copies are made? Are they necessary? Would fewer copies be sufficient? Are all copies business-related? Could the number of copies be reduced and, if so, how much could be saved?

Costs can be controlled through analysis. Costs can be controlled through observation. The combination of the two can be a powerful factor in reducing costs and improving profits.

PROFIT CENTERS

Demands of Growth

In small businesses with a single location, product, or selling department, it is usually sufficient to determine sales, costs, and profit for the total business in order to evaluate operations and take corrective action. However, as businesses grow and become more complex, they usually involve a variety of locations, products, or departments. Each of these must produce a profit on its own activities in order to ensure the success of the entire business.

Selecting Profit Centers

To evaluate and control the operations of each activity, it is common to divide the business into various profit centers. A profit center can be defined as any point within the business that is responsible for the generation of sales and control of costs.

Depending upon the nature of the business, the profit center selected might be any of the following:

- Selling department. This is typical of merchandising operations. For example, in a clothing store, the men's, women's, and children's departments might each be considered as separate profit centers.

- Geographic location. In small chains such as fast-food shops and dry cleaners, each location could be considered a separate profit center so that the profitability of each location could be evaluated.

- Product line. In businesses with a variety of products, it is useful to determine which products produce the most sales and profit. Therefore, each product would be considered a separate profit center.

- Customer. A wholesaler might serve a limited number of major accounts. Each account could be considered a separate profit center.

Cost Centers

Some businesses also have cost centers, points within the organization that incur costs and are, therefore, responsible for cost control although they do not generate sales directly and, therefore, cannot be held responsible for profit.

Typical cost centers could be an accounting department or shipping and receiving department. Their function is to provide needed services, not to generate sales directly.

Sub-centers

It can also be useful to establish sub-centers within each profit center, depending upon the information that would be of most value to the owners in making operating decisions. For example, a small retail chain with each store designated as a primary profit center would develop information on the profitability of each location so that the owners could determine the effectiveness of each manager and the desirability of each location. With this information, decisions could be made concerning expansion or termination of individual locations.

At each location, sub-centers could also be established according to various selling departments. This would permit evaluation of operations within the location.

* * * * *

1. A point within a business that is responsible for the generation of sales and control of costs is called a _____ center.

---

profit

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2. A point within the business that incurs costs, but has no responsibility or control with respect to sales, is called a _____ center.

---

cost

---

3. In a small department store, a selling department would be an example of a (PROFIT/COST) center.

PROFIT

---

4. In a small department store, the receiving department would be an example of a _____ center.

---

cost

---

5. List three typical classifications of profit centers.

1.
2.
3.

---

selling department
location
product line
customer
(ANY THREE ANSWERS ARE CORRECT)

---

6. Within each primary profit center, it is often useful to establish _____.

---

sub-centers

---

7. For a chain of small women's shops, the most useful profit center would probably be _____.

---

geographic location

---

8. For a manufacturer's representative handling six different products, the most useful profit center would probably be each different _____.

---

product

---

9. If a business had several sales representatives, each serving separate territories, the most useful cost center would probably be each representative's respective _____.

---

territory

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* * * * *

Application

As an example of the use of profit centers, refer to Exhibit 3, the one-month income statement for a small department store. The store consists of three departments: men's, women's, and children's. Sales, cost of sales, and operating expenses are shown separately for each department, as well as the total for the entire store. For example, the first line shows that total sales are broken down as follows:

Men's	$ 9,000
Women's	15,000
Children's	6,000
Total	$30,000

The second line reports cost of sales in each department and in total.

Cost of sales is then deducted from sales in each department to show gross profit for each department and in total. Gross profit breaks down as follows:

Men's	$ 3,600
Women's	5,000
Children's	2,400
Total	$11,000

Operating Expenses

Operating expenses are shown as direct and indirect. In each department, direct expenses are those incurred solely for operation of the particular department. Indirect expenses are those that are incurred to operate the business as a whole, not necessarily for any individual department.

Direct Costs

Direct costs can be either fixed or variable. For example, the salary of a salesperson assigned to a department would be a fixed direct cost since it would not necessarily be affected by fluctuations in month-to-month sales volume. The cost of alterations would be a variable direct expense since it would tend to increase as sales increase and decrease as sales decrease.

Operating Profit

Total direct costs are determined for each department and subtracted from gross profit to determine operating profit for each department. The operating profit appears on Exhibit 3 as follows:

Men's	$1,800
Women's	2,100
Children's	1,500
Total	$5,400

Indirect Costs

Besides direct costs, indirect costs must also be considered. These costs can be distributed, or allocated, to each department on some reasonable basis to determine the departmental profit for each department. The basis on which costs are allocated, or distributed, usually depends upon the nature of the particular expense.

Allocating Indirect Costs

The first indirect expense shown on Exhibit 3 is rent. Total rent expense is $2,000 per month. Rent can be allocated to each department depending upon the percentage of the total floor area that it occupies.

For example, the men's department occupies 25% of the total area. Therefore, its allocation of the total rent expense would be calculated as follows:

$$\$2,000 \times .25 = \$500$$

Similarly, the women's department occupies 50%. Therefore, its allocation would be calculated as follows:

$$\$2,000 \times .50 = \$1,000$$

The balance of the total floor space is 25%, occupied by the children's department. Therefore, its allocation of rent expense would be $500 ($2,000 x .25).

The allocation of rent expense is summarized on the following table:

Department	% of Total Floor Space	Rent Allocation
Men's	25%	$ 500
Women's	50	1,000
Children's	25	500
Total	100%	$2,000

The next indirect cost shown on Exhibit 3 is the owner's salary. Chances are, the owner of a business such as this has a variety of duties including buying, handling complaints, planning, public relations, directing advertising, supervising personnel, and hiring. How, then, should this salary be divided among the various departments? In some cases, it might be most practical to divide it according to estimated percentages of the owner's time spent in each department. In other cases, the owner may spend so little time directly involved in departmental problems that it might be more appropriate to allocate the manager's salary based upon sales. This approach has been used in developing Exhibit 3.

Selecting an Allocation Basis

In selecting an allocation basis for any indirect expense, you must consider the activities involved in the expense. For example, the accountant's activities probably depend upon sales in each department. Sales in each department would probably influence the amount of time required for such activities as recording sales, preparing invoices, posting journals, recording collections, and processing purchases. Therefore, the best allocation basis would probably be to distribute the accountant's salary among the departments in proportion to sales.

Utilities would tend to vary in proportion to the amount of space occupied since this would determine the cost required to heat, light, and cool the area. However, if specific factors about a particular department's utilities requirements were known, the cost could be assigned more specifically.

In the example of Exhibit 3, total indirect expenses in each department are as follows:

Men's	$1,200
Women's	2,200
Children's	1,000
Total	$4,400

For each department, total indirect expenses are subtracted from operating profit to determine the departmental profit. On Exhibit 3, profit in each department is shown as follows:

Men's	$ 600
Women's	(100)
Children's	500
Total	$1,000

* * * * *

1. Operating expenses can be classified as either direct or _____.

---

indirect

---

2. Costs incurred as a result of activities in a specific profit center are classified as (DIRECT/INDIRECT) costs.

DIRECT

---

3. Costs incurred as a result of operations of the business as a whole, and not entirely attributable to operations of one profit center, are considered _____ costs.

---

indirect

---

4. A chain of small grocery stores has a manager at each location. Each manager's salary is a(n) _____ cost of managing the store.

---

direct

---

5. The salary of an accountant who handles the books for the entire business would be a(n) _____ cost in each profit center.

---

indirect

---

6. Indirect costs are those incurred:

   a. entirely within a profit center
   b. as a result of operations of the business as a whole

---

   b. as a result of operations of the business as a whole

---

7. The procedure for distributing indirect costs among various profit centers is called _____.

---

allocation

---

8. How would rent expense usually be allocated among various profit centers?

In proportion to the area that each profit center occupies.

---

9. An employee's time is divided between two departments with 60% in Department A and 40% in Department B. How would the employee's $1,000 monthly salary be allocated between the two departments?

Department A: $_____
Department B: $_____

Department A: $600 ($1,000 x .60)
Department B: $400 ($1,000 x .40)

---

* * * * *

Direct Costs and Managerial Decisions

The owner of the store shown on Exhibit 3 reviews the monthly income statement and analyzes the profit contribution of each department. Noting that the men's and children's departments were both profitable while the women's department showed a $100 loss, could the owner conclude that total profit would be $100 higher if the women's department were discontinued? In all probability, the answer is "No."

Consider how the income statement of Exhibit 3 would be affected by closing the women's department. First, sales, cost of sales, and gross profit in the women's department would be eliminated. Therefore, total sales would be reduced to $15,000, cost of sales would be reduced to $9,000, and gross profit would shrink to $6,000 ($15,000 - $9,000). This is shown on Exhibit 4.

Direct costs of operating the women's department would probably be eliminated, since there would no longer be any need for sales personnel, advertising, or shipping. Therefore, these total costs would be reduced as shown on Exhibit 4.

However, consider the indirect costs. Chances are, none of these would be significantly reduced by discontinuing the women's department. The owner's salary would probably remain at $1,000. Unless the owner were able to sublet the space formerly occupied by the women's department, rent would probably continue at $2,000. The accountant's salary would probably continue, and only a small change in utilities could be expected since the entire space would still have to be heated and cooled. Therefore, total indirect expenses would probably remain at approximately $4,400, as shown on Exhibit 4.

Deducting total indirect expenses from the operating profit of $3,300, the manufacturer would then show a monthly loss of $1,100. Indirect costs have simply been shifted from the original three departments to the remaining two. While the women's department had appeared to be detrimental to the company's performance, it was, in fact, absorbing a substantial portion of indirect costs, reducing the burden on the other departments.

Relevant Costs

In considering decisions such as the continued operation of the women's department, the only relevant costs to consider are usually the direct costs of the operation. Indirect costs normally continue regardless of such a decision.

Purpose of Profit Centers

What, then, is the purpose of allocating indirect costs to various profit centers? Simply to develop a realistic measure of the operating profit that must be produced in each center for it to carry its share of indirect costs and produce a profit. By eliminating the women's department, $2,100 in monthly operating profit would be lost. However, $2,100 per month is not sufficient to cover the department's share of total indirect expenses. The profitability of the department, and probably the entire business, can only be increased by improving sales or gross profit in the department, or by reducing direct costs. The use of profit centers permits identification of products, locations, or personnel that are not "pulling their share of the load." Isolating these problem areas permits the owner to focus study and corrective action where they are most needed.

* * * * *

Answer the following questions and enter your answers on Exhibit 4.

1. The men's department now occupies 50% of the usable floor space. Therefore, its allocation of the total rent would be $_____.

$1,000 ($2,000 x .50)

---

2. The balance of rent allocated to the children's department would be $_____.

$1,000 ($2,000 - $1,000)

---

3. Allocate the owner's salary of $1,000 per month based upon sales. Men's department sales are _____% of revised total sales. Therefore, the portion of the owner's salary allocated to the men's department would be $_____.

60% ($9,000 ÷ $15,000)
$600 ($1,000 x .60)

---

4. The balance of the owner's salary allocated to the children's department would be $_____.

$400 ($1,000 - $600)

---

5. Distributing the accountant's salary based upon total sales in each department, the portion allocated to the men's department would be $_____ and the portion allocated to the children's department would be $_____.

$600 ($1,000 x .60)
$400 ($1,000 x .40 or $1,000 - $600)

---

6. Total utilities cost would then be allocated at $200 in the men's department and $200 in the children's department. Enter these amounts in the appropriate columns on Exhibit 4, and determine total indirect costs in each department.

Men's: $_____
Children's: $_____

Men's: $2,400
Children's: $2,000

---

7. The revised departmental operating profit or loss would then be as follows:

Men's: $_____
Children's: $_____
Total: $_____

Men's:	($ 600)	($1,800 - $2,400)
Children's:	($ 500)	($1,500 - $2,000)
Total:	($1,100)	($3,300 - $4,400)

---

* * * * *

LABOR COST CONTROL

Major Operating Expense

The most significant operating expense in many small businesses is labor. This includes not only the actual salaries and wages paid to an employee but also related expenses such as payroll taxes and fringe benefits.

Hiring Decision

To a large extent, control of labor costs is best exercised at the time that a decision is made to hire a new person, even before the person has been selected. Too often, people are hired to fill positions that may not need to be filled. The duties and responsibilities could just as well be handled by rearranging the duties of existing personnel, utilizing temporary help to fill temporary needs, or retaining an outside service such as a custodial or security service to fill the need at a lower cost.

Specifying the Position and the Person

Once a decision has been made to fill a position, a number of other important decisions must be made as follows:

. What type of person is needed to fill the position?

. What salary must be paid to be competitive in attracting a competent person?

. What fringe benefits must be offered in order to be competitive?

. What are the person's responsibilities?

. What qualifications are required?

When specifications have been drawn, you must recruit applicants and evaluate each according to his or her ability to perform the specified duties.

Wide Recruitment

Recruitment should be as wide as possible so as to attract the largest number of qualified applicants. In filling most positions, you want people who are not only qualified but also likely to remain on the job for a substantial period. Employee turnover costs can be exorbitant, and the need to recruit, hire, and train can place substantial demands on

your own time. The productivity of new employees is often low. Depending upon the nature of the business, sales could be lost or unnecessary expenses could be incurred while the new person is learning the job.

Applicant Review

When reviewing applicants for a position, you must consider these factors:

. Is the person's prior work experience or educational background relevant to the job at hand?

. Is the person capable of learning the job in a reasonable period of time?

. Is the person likely to be satisfied with the job and therefore willing to stay with it?

* * * * *

1. Which is the first question you must answer before hiring a person?

   a. Is the position necessary?
   b. What qualifications are needed to fill the position?
   c. Is this the right person for the job?

---

   a. Is the position necessary?

---

2. It is more important to fill the (NEED/POSITION).

   NEED

---

3. Why is it preferable to hire people who are likely to remain on the job for a significant period of time?

   To reduce turnover costs.

---

4. Besides cost, name two other reasons why a high employee turnover is undesirable:

   1.
   2.

Time required for recruitment, selection, and training.
Lost productivity.

---

* * * * *

Cost Control

For all employees, there are a number of steps that you can take to control labor costs. Each employee should be required to provide a time record for each payroll period. This record should show not only the total hours spent on the job to determine earnings but also how that time was spent. How many hours were spent on each particular activity or in each department?

Overtime

The cost of overtime must be closely controlled. All overtime should require a written authorization signed by a supervisor. The authorization should include not only the number of hours but also the purpose of the overtime.

Absenteeism

Incidental absences should be watched carefully. Occasional absence for serious illness is seldom as costly and disruptive as incidental absence. If a person is sick for a week, you can usually make alternate arrangements by rearranging assignments or hiring temporary personnel to fill a need. However, the frequent phone call at the last minute to announce a one-day absence can disrupt your plans and allow you no time to make alternate arrangements.

Productivity

Employees' productivity must be observed. In some cases, productivity can easily be measured in terms of sales, merchandise handled, etc. Productivity can be improved through training, closer supervision, or attention to working methods and habits.

Performance Review

Employees' performance should be reviewed regularly so that all employees understand whether or not their performance is up to expectations.

COST CONTROL -- PURCHASED GOODS AND SERVICES

Major Element

In most retail and wholesale operations, the largest single element of cost is the cost of merchandise purchased for sale to customers. This cost must be closely controlled so that you can maintain competitive prices in the market while generating sufficient gross profit on sales to cover your operating expenses and realize an adequate net profit to justify your investment.

Competitive Sources of Supply

Controlling the cost of purchases begins with maintaining competitive sources of supply. If you are buying an item for the first time, you should contact several competitive suppliers to be sure that you are receiving the best available price and can expect the service and quality that you need. All suppliers should realize that they are in a competitive situation and can only secure your business by submitting the lowest possible price while adhering to your standards for quality, delivery, etc.

Advantages

Besides realizing more favorable prices, the use of competitive suppliers has other advantages. There will be times when a supplier cannot deliver what you need when you need it. When this occurs, your ability to secure needed goods from other suppliers may depend upon your past relations with them. If you put "all your eggs in one basket" with a single supplier, it may be difficult to find alternate resources when an urgent need arises.

Requesting Quotations

When requesting price quotations from suppliers, you will realize more favorable prices by being <u>specific in your request</u> since bidders will not have to allow for as many uncertainties in preparing their estimates.

Require complete quotations from all bidders. Be sure that quotations include the following:

- Quantities
- Unit prices
- Shipping terms
- Cash discounts
- Delivery schedules

Comparing Total Costs

After you have received quotations, compare total costs. For example, look at the quotations shown below. They were received from two suppliers, A and B, for 1,000 widgets.

	Supplier A	Supplier B
Price	$5,000	$5,500
Shipping time	FOB shipping point	FOB your store
Cash Discount	None	2%, 10 days

Supplier A quoted $5,000; Supplier B quoted $5,500. On the surface, the quotation from Supplier A would appear more favorable. However, other factors must be considered.

For example, the shipping terms offered by Supplier A were "FOB shipping point" and those offered by Supplier B were "FOB your store." Therefore, in the case of Supplier A you would be responsible for shipping charges and should include your estimated shipping costs to make a reasonable comparison.

Supplier B offered a cash discount of 2% for payment within 10 days, while Supplier A offered none. This must also be translated into dollars. If you are unable to make payment within 10 days, the 2% cash discount offered by Supplier B would be of no value to you. However, if you can, then the $110 cash discount ($5,500 x .02) effectively lowers the quotation to $5,390.

Purchase Order

Before placing an order with any supplier, prepare a purchase order specifying the following:

- Description of goods
- Quantity
- Quality, if applicable
- Unit price
- FOB point
- Shipping method
- Delivery schedule

If the supplier should later default on any item such as delivery date, product quality, or quantity, you would have a justifiable claim which would carry more weight than a verbal agreement.

* * * * *

1. Name two advantages of maintaining competitive sources of supply:

   1.
   2.

   Competitive prices and terms.
   Alternate source of supply.

---

2. How can you realize more favorable prices on purchased goods by being as precise as possible in specifying your requirements?

   The supplier does not have to include any factor for contingencies, or uncertainties.

---

3. Besides price, what other factors might you consider in comparing quotations from separate suppliers?

---

   shipping terms
   discount structure
   delivery capability
   product quality

---

4. The document on which you formally place an order with a supplier is called a _____ order.

---

   purchase

---

5. How could a purchase order protect you if a dispute later arose over price?

You would have formal documentation of your order.

---

6. Suppliers A and B each quote on 100 wrenches for your hardware store. Their quotes are as follows:

	Supplier A	Supplier B
Unit price	$7.50	$7.00
Shipping terms	FOB your store	FOB shipping point
Cash discount	2%, 10 days	none
Delivery date	3-15	3-15

Assuming that shipping costs from Supplier A's plant are approximately $30 and you can take advantage of the cash discount, your net cost of purchasing 100 wrenches from Supplier A would be $_____.

$735 ($7.50 x 100 + $0 shipping - $15 cash discount)

---

7. Assuming that shipping costs are $45 from Suppliers B's plant, your net cost of purchasing from Supplier B would be $_____.

$745 ($7.00 x 100 + $45 shipping - $0 cash discount)

---

8. The more favorable net cost is available from Supplier (A/B).

A ($735 vs. $745)

---

* * * * *

Receiving Procedures

Just as care must be taken in initiating a purchase, control should be exercised when merchandise is received to be sure that you receive what you ordered and pay only for what you received.

When goods are received, you are given the carrier's shipping papers. These must be signed to acknowledge receipt of the goods. The shipping papers indicate the number of cartons in which the shipment arrived. Before signing the shipping papers, the cartons should be counted to be sure that the number actually received agrees with that shown on the papers. If any difference is noted, it must be indicated on the shipping papers before you sign them.

All cartons should be examined for signs of visible damage. If so, there is reason to believe that some of the merchandise within may be damaged. Since you probably cannot inspect the merchandise immediately, you should note the condition on the shipping papers prior to signing. The driver should also sign your copy of the shipping papers to avoid the possibility of a later dispute.

Packing List/Invoice

When the cartons have been opened, you will probably find a packing list or invoice accompanying the shipment. The packing list (or invoice) should identify each item included in the shipment along with the quantity shipped.

You should then count the exact quantity of each item received and compare it with that shown on the packing list. If any discrepancy is noted, the quantity shown on the packing list should be crossed out, the actual quantity entered, and the supplier notified immediately.

Invoice Processing

No supplier's invoice should be processed for payment unless it agrees with the information shown on the packing list and is verified at the time of receipt as well as the price and terms specified on your purchase order. If there are any discrepancies in prices or quantities between those shown on the invoice and those shown on the purchase order, the supplier should be contacted before payment is made. Similarly, if there are any differences between quantities received and those shown on the invoice, the supplier should be contacted.

* * * * *

1. A trucker makes a delivery to your store. The shipping papers indicate that 15 cartons are included. What should you do before signing the shipping papers?

Count the cartons.

---

2. If your count disagrees with that shown on the shipping papers, what action should you take?

Note the difference on the shipping papers before signing.

---

3. While counting the cartons, what else should you do?

Note their condition.

---

4. What action should you take if a carton has visible damage?

Note it on the shipping papers before signing.

---

5. When the cartons are open, you can expect to find a _____ describing the contents of the shipment.

---

packing list (in some cases, an invoice)

---

6. When the invoice is received, quantities shown should be compared with those actually received as indicated on the _____.

---

packing list

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7. Prices shown on the invoice should be compared with those on the _____ that you originally submitted to the supplier.

---

purchase order

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* * * * *

SUMMARY

Continuing Responsibility

Cost control requires a continuing effort. Without close attention, costs inevitably tend to rise. Owners tend to become less aggressive in seeking the most favorable price for purchased goods and services. Lax supervision permits labor costs to get out of line and waste creeps into the company's cost structure.

Regular Review

Unless costs are reviewed regularly and prompt corrective action is taken, your business will soon find its profit margin shrinking, leading to losses and a weak competitive position in the market.

As the owner of a business in an economy based upon free enterprise, you may have relatively little control over the price you receive for your product or service. Competition in the marketplace will determine this for you. However, you can control the costs that you incur so that your business can generate the profit it needs to prosper and grow while compensating you fairly for your investment.

Booklet

In this booklet, you have learned a number of principles that can be applied to any retail or wholesale operation in order to reduce costs and improve profits. You can identify excessive costs that require prompt attention. You can apply sound principles of decision-making to evaluate cost alternatives. You can control the cost of labor on a continuing basis. Finally, you can control the cost of purchased goods and services so that you buy only what you need and buy it at the most favorable price.

Application of these principles of cost control to your business can help you to realize more profit from every dollar of sales.

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EXHIBIT 1

VILLAGE HARDWARE

INCOME STATEMENT
1979

		$	% SALES
Sales		$200,000	100.0%
Cost of Goods Sold		130,000	65.0
Gross Profit		$ 70,000	35.0%
Operating Expenses			
Owner's Salary	$12,000		6.0%
Sales Personnel Salaries	16,000		8.0
Clerical Salary	8,000		4.0
Payroll Taxes	2,000		1.0
Employee Benefits	1,000		0.5
Rent	5,000		2.5
Utilities	2,000		1.0
Advertising	2,000		1.0
Delivery	1,000		0.5
Travel	2,000		1.0
Telephone	1,000		0.5
Bad Debts	2,000		1.0
Supplies	2,000		1.0
Insurance	2,000		1.0
Depreciation	1,000		0.5
Interest	1,000		0.5
Miscellaneous	-		0.0
Total Operating Expenses		$ 60,000	30.0%
Net Profit (Before Income Tax)		$ 10,000	5.0%

EXHIBIT 2

VILLAGE HARDWARE

INDUSTRY COMPARISON
1979

		$	% SALES	INDUSTRY
Sales		$200,000	100.0%	100.0%
Cost of Goods Sold		130,000	65.0	65.0
Gross Profit		$ 70,000	35.0%	35.0%
Operating Expenses				
Owner's Salary	$12,000		6.0%	6.0%
Sales Personnel Salaries	16,000		8.0	6.7
Clerical Salary	8,000		4.0	1.3
Payroll Taxes	2,000		1.0	0.7
Employee Benefits	1,000		0.5	0.4
Rent	5,000		2.5	2.9
Utilities	2,000		1.0	0.8
Advertising	2,000		1.0	1.5
Delivery	1,000		0.5	0.4
Travel	2,000		1.0	0.2
Telephone	1,000		0.5	0.3
Bad Debts	2,000		1.0	0.2
Supplies	2,000		1.0	0.7
Insurance	2,000		1.0	0.7
Depreciation	1,000		0.5	0.6
Interest	1,000		0.5	0.4
Miscellaneous	-		0.0	1.4
Total Operating Expenses		$ 60,000	30.0%	25.2%
Net Profit (Before Income Tax)		$ 10,000	5.0%	9.8%

EXHIBIT 3

PROFIT CENTER SUMMARY
1979

	MEN'S	WOMEN'S	CHILDREN'S	TOTAL
SALES:	$9,000	$15,000	$6,000	$30,000
Cost of Sales	5,400	10,000	3,600	19,000
Gross Profit	$3,600	$ 5,000	$2,400	$11,000
DIRECT EXPENSES:				
Salaries - Sales	$1,000	$ 1,700	$ 500	$ 3,200
Advertising	500	700	200	1,400
Alterations	200	300	100	600
Shipping	100	200	100	400
TOTAL DIRECT	$1,800	$ 2,900	$ 900	$ 5,600
OPERATING PROFIT	$1,800	$ 2,100	$1,500	$ 5,400
INDIRECT EXPENSES:				
Rent	$ 500	$ 1,000	$ 500	$ 2,000
Salary - Owner	300	500	200	1,000
Salary - Accountant	300	500	200	1,000
Utilities	100	200	100	400
TOTAL INDIRECT	$1,200	$ 2,200	$1,000	$ 4,400
DEPT. PROFIT/(LOSS)	$ 600	($ 100)	$ 500	$ 1,000

EXHIBIT 4

PRO FORMA INCOME STATEMENT
1979

	MEN'S	CHILDREN'S	TOTAL
SALES:	$9,000	$6,000	$15,000
Cost of Sales	5,400	3,600	9,000
Gross Profit	$3,600	$2,400	$ 6,000
DIRECT EXPENSES:			
Salaries - Sales	$1,000	$ 500	$ 1,500
Advertising	500	200	700
Alterations	200	100	300
Shipping	100	100	200
TOTAL DIRECT	$1,800	$ 900	$ 2,700
OPERATING PROFIT	$1,800	$1,500	$ 3,300
INDIRECT EXPENSES:			
Rent	$_____	$_____	$ 2,000
Salary - Owner	_____	_____	1,000
Salary - Accountant	_____	_____	1,000
Utilities	_____	_____	400
TOTAL INDIRECT	$_____	$_____	$ 4,400
DEPT. PROFIT/(LOSS)	$_____	$_____	($ 1,100)

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